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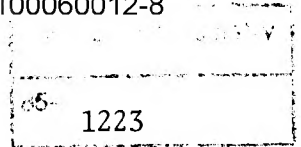
Remarks To 20: Please respond direct (as appropriate) with copy to ER. If there is anything here the DCI ought to be apprised of, please provide your comments.

Executive Secretary
2 May 1985

Date

3637 (10-81)

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Center for Strategic & International Studies
Georgetown University • Washington DC

April 29, 1985

The Honorable William J. Casey
Director
Central Intelligence Agency
Washington, DC 20505

Dear Mr. Casey:

For nearly four decades, reports of the impending demise of the Western alliance have tended to be greatly exaggerated. Despite the alliance's resilience, however, the broad range of enduring and emerging challenges are not slackening and, in some areas, are increasing. It may well be that at this juncture, the political basis for the alliance can be most effectively reinforced through Western economic initiatives.

Previous CSIS Contingency Papers have addressed the nature and future of the Western alliance. In this paper, John Yochelson, Director of International Business and Economics at CSIS, analyzes the trends in the world economy and applies those findings in prescribing certain policy actions for the alliance. Regardless of whether or not the alliance can best be reinforced through economic initiatives, John proposes an important economic and political context for the May summit meeting in Bonn and beyond.

Sincerely,

A handwritten signature in dark ink, appearing to be "H. Ullman", followed by a horizontal line.

Harlan K. Ullman
Project Director

C • S • I • S

CONTINGENCIES PROJECT

CENTER FOR STRATEGIC &
INTERNATIONAL STUDIES
GEORGETOWN UNIVERSITY

The Bonn Summit and Beyond:
U.S. Policy Perspectives and Prescriptions

John Yochelson

April 29, 1985

The Bonn Summit and Beyond:

U.S. Policy Perspectives and Prescriptions

In spite of strong improvement in the world economy led by the United States, heads of Western governments face continuing, difficult economic challenges. Patterns of growth and trade of the Organization for Economic Cooperation and Development (OECD) countries are askew. Global recovery has not eased strains on the international trading system. Economic growth in developing states needed to reduce the international debt problem is by no means assured. The political will to address the economic agenda of the West has not been actively demonstrated throughout the Western alliance. Yet, sustained economic recovery is a political and economic necessity.

This year's Bonn Summit, to be held in early May, could be of pivotal significance if the West is to meet these challenges effectively. U.S. resurgence dominates the global economy and shapes the setting of this year's summit. U.S. economic performance in 1983-1984 produced impressive gains in real GNP growth, productivity, and capital investment. Inflation was held below 3.5 percent and unemployment dropped steeply. Current estimates forecast continuing real U.S. GNP growth in 1985 without renewed inflation, although the level of that growth is by no means certain.

On the positive side for the West, the strength of the U.S. economy has reinforced the U.S. leadership position not only on international economic issues but also in broader political terms. The seemingly inevitable U.S. economic decline that prevailed in the 1970s has been reversed.

In addition, U.S. economic recovery has pumped timely and vitally needed demand into the world economy. Since mid-1982, the United States has absorbed more than 65 percent of the increase in non-OPEC developing country exports and almost 85 percent of the increase in Latin American imports. At the same time, the surge in U.S. demand has provided a tremendous boost to the advanced industrial economies.

The dynamism of the U.S. economy has also eased certain longer-term internal structural adjustment problems. The creation of more than 6 million new jobs since 1981 has offset a decline in manufacturing employment and speeded the shift of resources from the goods-producing to the services sector. Strong gains in output, productivity, and employment have been registered in high technology industries.

Nevertheless, there has been a negative aspect to U.S. economic resurgence. The soaring dollar has put U.S. industry under relentless pressure from international competition. From 1983 to 1984, the U.S. trade deficit increased by nearly 80 percent to \$123 billion. Longstanding surpluses in sectors of comparative U.S. advantage -- agriculture, advanced technology, and services -- have either declined or collapsed altogether. The U.S. share of foreign markets shrank, while a 30 percent increase in imports cut heavily into the U.S. domestic market because of the dollar's strength.

The strong dollar has also constrained U.S. trading partners, putting them under pressure to keep interest rates high enough to stem capital outflow. The rising value of U.S. currency has increased costs of key dollar-denominated commodities. Relatively high U.S. interest rates have added to the debt-servicing burden of the developing countries because much of their debt is denominated in dollars.

The coincidence of record budget and trade deficits has raised questions about the sustainability of the U.S. recovery. Thus far, worst case scenarios have, fortunately, been far off the mark. But there is still concern that projected budget and trade deficits will crowd out domestic investment and push the United States into a net debtor position internationally -- undermining confidence in the U.S. economy and touching off a destabilizing run on the dollar.

On balance, the benefits of U.S. resurgence substantially outweigh the problems associated with it, provided the United States can sustain the projected 3.5 percent growth rate in 1985 and beyond. Thus, substantial growth in the U.S. economy remains central to OECD economic health.

Toward Balanced Growth: OECD Countries

Clearly, expansion in the United States alone cannot carry the global economy. More balanced growth by the advanced industrial economies is essential to bring down the dollar and improve the prospects of the developing countries.

With rare exception, Japan has outperformed other OECD economies since the early 1960s, and its industrial weight has been increasingly on a global basis. This pattern will continue in 1985. The investment and export-driven character of the Japanese economy, however, diminishes its imports of manufactured goods; the locomotive power of the Japanese economy will not be fully realized until its large current account surplus is substantially reduced.

More worrisome is the slow pace of OECD Europe's recovery, which will be less than 2.5 percent overall this calendar year. Europe's modest cyclical recovery reflects longer-term structural problems. OECD Europe has consistently underperformed both the

United States and Japan since the 1973-1974 oil embargo. The size of the European work force has remained flat since then. The inability to generate new jobs has created an oversupply of labor, leaving severe problems of youth and longer-term unemployment. Lags in investment and the rigidity of labor markets have contributed to a pattern of sustained stagnation. Resistance to change has been particularly strong in basic industries, while Europe's high technology base has not developed as rapidly as that of the United States or Japan.

Europe has shown signs of addressing the challenge of its revitalization. Governments of all political colors have put increasing the mobility of labor and capital, cutting the structural budget deficits, and tapping the energies of the private sector higher on their agendas. Many Europeans now acknowledge the need to reduce remaining barriers to economic growth within the European Community.

No development would be more beneficial for the world economy and the West than sustained European resurgence. The erosion of European self-confidence -- reflected in persistent capital flight and the increased appeal in some parts of Europe of protectionist approaches to trade and investment -- remains a serious threat to the long-term interests of Europe and its trading partners.

The recovery of Canada is of special importance to the United States because of the interdependence of the two economies. The strong growth that Canada achieved in 1984 was led by an increase in exports, particularly to the U.S. market. Despite this cyclical upturn, Canadian unemployment remains high, business investment sluggish, and budget deficits at historic levels.

Clearly, lasting disparities of growth and trade are as much a political as an economic threat to the West. They are bound to call into question basic issues of fairness and to reshape public attitudes on all sides. They cannot help but spill over into the political arena. One measure of the danger is the fact that the bilateral agendas of the advanced industrial economies have rarely been more crowded with contentious issues.

Resuming Growth: Developing Countries

The long-term health of the world economy depends as much on the resumption of LDC growth as it does on the vitality of the advanced industrial countries.

Some have suggested, on the basis of progress during the past year, that the less developed country's (LDC) debt crisis of 1982-1983 has passed. Several of the key debtor countries, most notably Brazil and Mexico, have achieved remarkable economic turnarounds -- especially in their trade balances -- by

implementing austerity measures. The International Monetary Fund (IMF) has played a decisive role in the introduction of stabilization programs that, in turn, have led to the successful conclusion of a series of difficult rescheduling negotiations. Lending banks have not cut and run but rather have accepted some narrowing of their margins of profit. The moderation of U.S. interest rates has relieved some of the pressure on the debtors, while the U.S. market has absorbed the lion's share of their exports.

Nevertheless, a return to the 1970s era of mutually reinforcing LDC and OECD growth is certainly not at hand. There have been notable exceptions to the strong performances of some developing countries. Virtually all the developing countries were unable to contain inflation within targeted levels. The inability of several major debtors states to meet the belt-tightening and restructuring conditions set by the IMF has renewed widespread concern over their political capacity to undertake needed economic measures. Furthermore, increased inflows of private sector capital failed to materialize, capital flight remained a problem, and the continuation of depressed commodity prices reduced LDC export earnings.

A formidable set of conditions must still be met to put the developing countries on a path toward healthy growth.

- o The LDCs will not only have to stay the course of austerity through further cuts in public sector expenditures but shift resources to more productive uses, widen the scope for private sector initiative, increase incentives to attract foreign investment, and reduce barriers to imports while expanding exports.

- o The advanced industrial economies will have to ensure continued access to their home markets, not just for LDC commodities but for the manufactured goods that have put old-line industries in the OECD countries under intense pressure. The advanced economies will also have to support the key multilateral lending institutions, the IMF and the World Bank, whose role will remain central.

- o The IMF will have to provide continued surveillance of LDC economic performance and serve as the key broker between debtors and private bank lenders -- exerting the leverage and creating the incentives for both sets of parties to cooperate. These tasks are likely to translate into new IMF funding requirements.

- o The World Bank will have to continue its shift of emphasis away from long-term capital projects toward the near and medium-term restructuring of LDC economies. The World Bank and the IMF must cooperate more closely in their country activities.

- o Additional resources will have to be secured for the lower-tier LDCs, many of which face bleak prospects made worse

by severe famine.

- o Commercial banks will have to lend in sufficient volume to sustain the process of debt rescheduling.

- o U.S. interest rates will have to remain relatively low to keep the debt burden within tolerable limits.

- o Energy prices will also have to stay relatively stable because sharp fluctuations will adversely affect either oil-producing or oil-importing LDCs.

The International Trading System

Concern over the future of the international trading system may be at a postwar high despite the present global economic upturn. The trading system is no longer regarded as the primary engine of economic growth. But the trading system carries a greater burden than ever as the linchpin of any strategy to overcome the international debt problem. This anomaly should give much pause to Western leaders.

A number of factors account for increasingly sober Western perspectives on the international trading system.

First, enormous financial flows have affected the trading system dramatically through their impact on exchange rates. These financial flows, estimated by the U.S. Treasury to be at least 15 times greater than the \$1.8 trillion value of world trade in 1984, have swamped trade surpluses and deficits in determining rates of exchange between currencies -- as the 50 percent rise of the dollar relative to other currencies since 1981 has shown. Coordinated efforts to stabilize exchange rates have been temporarily effective at best, given the scale of the international capital market. The competitive positions of Western economies are thus being decisively shaped by powerful yet elusive forces.

Second, pressures on governments to intervene in trade matters continue to rise. The integration of international markets has exposed vulnerabilities and created opportunities that have increasingly involved national authorities for wide-ranging reasons: to shield declining industries or protect newly established ones, to boost export earnings, to secure competitive advantage in overseas markets, and to overcome foreign exchange shortages. The practice of managed trade has become more a norm than an exception in constraining market forces in every major sector of international commerce.

Third, Japan's current account surplus, which reached \$35 billion with the United States alone in 1984, has become a major flashpoint. The world envies the strengths of the Japanese economy that underlie its superior trade performance. But successive Japanese initiatives to reduce tariffs,

internationalize the yen, and improve market access in other ways have failed to shake the widely held view that the Japanese market is less open than those of other advanced economies.

Fourth, the newly industrializing countries (NICs) have generally resisted the adjustment of their positions within the international trading system to reflect new realities. The NICs have pressed their advantage in technologically simpler, labor-intensive industries, such as steel, textiles, and shipbuilding -- increasing global capacity in these industries far more rapidly than demand. The NICs seek expanded access to overseas markets in these basic industries, but they also maintain barriers around their own domestic markets. The combination of aggressive export policies and domestic protectionism has been a particular source of stress, especially as regards the large trade surpluses that have been built up by the Pacific Rim NICs.

Fifth, the trading system is not generating the anticipated growth. By most accounts, the extraordinary expansion of U.S. imports should have spurred stronger and more rapid recoveries for trading partners than it has. Although export capacity has been built up to respond to increasing U.S. demand, the relatively weak transmission of this demand into overseas growth has raised questions about leakage elsewhere in the world economy.

These questions and issues cloud the resilience of the international trading system and generally have placed all governments on the economic defensive. All concede the net benefits of open world markets, yet the practical costs of adhering to that standard are increasingly heavy. Under these conditions, it is hardly surprising that the credibility of the General Agreement on Tariffs and Trade (GATT) as a forum for addressing the current trade agenda has diminished.

The uncertain future of the international trading system calls for vigorous action at the Bonn Summit and beyond, especially because the lofty rhetoric of recent summit declarations has not squared well with the actual practice.

- o Western leaders should start the process of beginning a new round of international trade negotiations as forcefully as possible by setting a specific target date.

- o Western leaders should lay out the negotiating objectives of the new round, namely: (1) to negotiate rules for key sectors that are uncovered under GATT including services, advanced technology, and agriculture, (2) to strengthen the adjudication process of GATT, (3) to define more specifically safeguard procedures that allow for temporary relief from GATT commitments.

It would be unrealistic for the advanced industrial economies to make all progress in trade negotiations contingent upon the achievement of a consensus binding the more than 120

signatories of G. I. Western leaders should be prepared to lay down a marker that they will, if necessary, negotiate on a more selective basis with nations that are ready to assume mutual obligations. Although more selective talks do not represent a best case solution, they reflect current realities and they may create helpful momentum for more comprehensive negotiations.

Technology

Technology is perhaps the most dynamic factor affecting all of these variables. It has proved a decisive Western asset across the board: an engine for growth; a link between the advanced industrial economies; a magnet drawing the developing countries toward the West; and, in the military sphere, an equalizer of Soviet numerical superiority. The U.S. Strategic Defense Initiative (SDI) should be seen as part of a historic pattern of relying on technology to offset Soviet strengths.

At the same time, however, technology has a clear capacity to divide the alliance because it cuts to the heart of vital commercial interests and to the core of the East-West military balance. Within the West, the progressive blurring of commercial and military applications of technology has added new complexities. On the strategic level, SDI has raised important new issues regarding the development and use of Western technological leverage in arms talks.

Policy Recommendations

Only a multilateral approach can effectively address current challenges to the global economy.

- - The United States should pursue significant and sustained reductions in its overall budget, preferably through cuts in government spending. The gradual reduction of the deficit is integral to the lowering of interest rates and a soft landing of the dollar. Unilateral U.S. efforts to deal with its trade deficit -- whether through deflation or import surcharges -- will only increase prospects for a destabilizing, hard landing of the dollar.
- - Europe must overcome serious rigidities in its labor markets and the inefficiencies caused by the failure of the European Community to develop into a genuine Common Market. Some leeway exists for a stimulus to domestic demand in Europe, given stable or falling inflation rates and rising current account surpluses. Policy shifts to foster growth and lower unemployment should include a reduction in tax burdens and a general reform of tax structures. These policy shifts become especially important in the context of slowing U.S. growth.

- - Japan must act promptly to reduce its massive trade surplus. To do so, Japan must alter traditional customs and attitudes that stand in the way of importing more goods, especially manufactured goods. Although recent Japanese initiatives to reduce the trade surplus are a positive step, results are now awaited. Curbing the high rate of personal savings in Japan and reducing unnecessary bureaucratic intervention are also essential.
- - The developing countries must undertake fundamental revisions of domestic policy that will complement balance of payments adjustments that have already taken place. Until a healthier private sector climate develops in the LDCs and capital flight is correspondingly slowed, the debtor nations will remain economically fragile and unable to service their obligations over the long term. The LDCs must achieve sustained growth through fundamental economic reforms before banks will resume voluntary lending. The burden of structural adjustment, however, should not be thrown exclusively on the LDCs, who require increasing access to the industrialized countries' markets.
- - The inauguration of multilateral trade negotiations must be treated as a top priority.
- - It is essential that Western leaders deepen their understanding of the impact of technology on Western interests.

The Bonn Summit provides an excellent opportunity to begin that objective over the next two years.

CENTER FOR STRATEGIC &
INTERNATIONAL STUDIES
GEORGETOWN UNIVERSITY
1800 K Street, N.W.
Suite 400
Washington, D.C. 20006
(202) 887-0200